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The New Partnership Audit Regime Will Be Here Soon – Are You Ready?

By Larry Brant on 6.9.16 | Posted in Individual Income Tax, Internal Revenue Service, Legislation, Limited Liability Companies (LLCs), Partnership Tax, Tax Laws, Tax Planning, Tax Procedure

On November 2, 2015, the Bipartisan Budget Act ("Act") was signed into law by President Barack Obama. One of the many provisions of the Act significantly impacts: (i) the manner in which entities taxed as partnerships[1] will be audited by the Internal Revenue Service ("IRS"); and (ii) who is required to pay the tax resulting from any corresponding audit adjustments. These new rules generally are effective for tax years beginning after December 31, 2017. As discussed below, because of the nature of these rules, **partnerships need to consider taking action now in anticipation of the new rules.**

The Current Landscape

Entities taxed as partnerships generally do not pay income tax. Rather, they compute and report their taxable income and losses on IRS Form 1065. The partnership provides each of its partners with a Schedule K-1, which allows the partners to report to the IRS their share of the partnership's income or loss on their own tax returns and pay the corresponding tax. Upon audit, pursuant to uniform audit procedures enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), examinations of partnerships are conducted generally under one of the following scenarios:

- For partnerships with ten (10) or fewer eligible partners,[2] examinations are conducted by a separate audit of the partnership and then an audit of each of the partners;

- For partnerships with greater than ten (10) partners and/or partnerships with ineligible partners, examinations are conducted under uniform TEFRA audit procedures, whereby the examination, conducted at the partnership level, is binding on the taxpayers who were partners of the partnership **during the year under examination**; and

- For partnerships with 100 or more partners, at the election of the partnership, examinations may be conducted under uniform "Electing Large Partnership" audit

> procedures, whereby the examination, conducted at the partnership level, is binding on the partners of the partnership **existing at the conclusion of the audit**.

Lawmakers believed a change in TEFRA audit framework was necessary for the efficient administration of Subchapter K of the Code. If a C corporation is audited, the IRS can assess an additional tax owing against a single taxpayer—the very taxpayer under examination—the C corporation. In the partnership space, however, despite the possible application of the uniform audit procedures, the IRS is required to examine the partnership and then assess and collect tax from multiple taxpayers (i.e., the partners of the partnership). In fact, the Government Accountability Office (the "GAO") reported in 2014 that, for tax year 2012, less than one percent (1%) of partnerships with more than $100 million in assets were audited. Whereas, for the same tax year, more than twenty-seven percent (27%) of similarly-sized corporations were audited. The GAO concluded the vast disparity is directly related to the increased administrative burden placed on the IRS under the existing partnership examination rules.

New Law

Effective for tax years beginning on or after January 1, 2018, new centralized examination rules may apply to entities taxed as partnerships. Under the new rules, it is expected the number of partnerships that will be subjected to IRS examination each year will dramatically increase.

While Congress has already enacted this new statutory audit regime, Treasury has yet to publish regulations providing taxpayers with much needed guidance on the application of the rules. Most tax practitioners expect regulations will be published within the next twelve (12) months.

As stated above, the new rules apply for tax years beginning on or after January 1, 2018. Partnerships may, however, elect to apply the new rules to any returns filed for tax years beginning after November 2, 2015 (the date President Obama signed the new rules into law).

An Overview of the New Rules

The following is a broad summary of the key aspects of the new partnership audit rules:

Application to All Partnerships. Except for eligible partnerships that affirmatively "elect out" of the new audit regime, these rules apply to all partnerships.[3]

Annual Election Out; Implications. A partnership is eligible to "elect out" of the new audit regime,[4] if:

- The partnership issues 100 or fewer Schedule K-1s for the tax year[5]; and

- Each of the partners of the partnership during the tax year is:
  - An individual;
  - A C corporation;
  - A foreign entity that would be treated as a C corporation if it were domestic;
  - An S corporation; or
  - An estate of a deceased partner.

Thus, partnerships with partners that are entities taxed as partnerships or that are trusts are ineligible to "elect out" of the new audit regime. If a partnership "elects out" of the new audit regime, the pre-TEFRA audit rules apply under which any audits involving partnership items occur at the partner level.

Partnership Representative Requirement. Each partnership (other than partnerships which properly "elect out") is required to appoint a Partnership Representative ("PSR"). The PSR has sole authority to act on behalf of the partnership for purposes of the new audit rules. If the partnership does not appoint a PSR, the IRS may select a PSR for the partnership. The PSR is similar in concept to the "Tax Matters Partner" under the TEFRA audit regime.

Audit Adjustments; Imputed Underpayment. Generally, audit adjustments of income, gain, loss, deduction, or credit will be made by the IRS at the partnership level with respect to any tax year under audit (i.e., a "reviewed year"). Under the new audit regime, the IRS will assess and collect from the **partnership**, rather than the partners, any resulting underpayment of tax (the "imputed underpayment") calculated at the highest corporate or individual income tax rate in effect during the reviewed year.[6] The tax is assessed in the year in which the audit (or judicial review) is completed (i.e., the "adjustment year"). In addition, the partnership is directly liable for any related penalties and interest.

This is a huge change. Under this new framework, the economic burden of a tax assessment resulting from an audit falls on persons who are partners in the **adjustment year**, rather than persons who were partners during the reviewed year(s) to which the partnership adjustments are attributable. It is, however, expected to significantly reduce the administrative burden on the IRS (which has encountered substantial budget cuts in recent years, reducing its audit and collections staff).

Alternative Payment Election. The Act allows partnerships to elect to use an alternative payment system whereby the liability to pay any assessment is transferred to the reviewed-year partners. The election applies with respect to each imputed underpayment assessed against the partnership and must be made no later than 45 days after the date the partnership receives the notice of audit adjustments. Once made, the election is revocable only with the IRS's consent.

The partnership must notify each partner of the partnership during each the **reviewed** year(s) of their share of audit adjustments for such years in a manner and time provided by future IRS guidance. Each reviewed-year partner then must take into account the reviewed-year adjustments and pay any additional tax with its return for the **adjustment year**, along with related penalties and interest calculated from the reviewed year(s) at the federal underpayment rate plus two percent (2%). Each partner is only liable for its own share of the tax (i.e., there is no joint and several liability).

This election shifts the economic burden of any assessment back to each reviewed-year partner and prevents the burden from being shifted to different partners if there is a change in partners (in terms of percentage ownership or otherwise) between the review year(s) and the adjustment year; however, it effectively precludes any partner from challenging the assessment. The details and methodology surrounding this alternative payment election have not yet been created by Treasury.

Application

Without guidance in the form of Treasury Regulations, taxpayers are somewhat in the dark as to the application of the new partnership audit rules. Some guidelines or issues, however, should be considered by partnerships before the rules go into effect, including, without limitation, the following:

- Whether the new audit regime should be adopted early. Without guidance from Treasury, most taxpayers will likely avoid early adoption.

- Careful review of each partnership and its partners is required to see if the partnership is eligible to “elect out” of the new audit regime. If it can “elect out,” most tax practitioners believe a partnership should do so. Again, it appears the “elect out” option must be exercised annually.

- Consider amending each partnership agreement to restrict ownership (and the transferability of partnership interests) to persons or entities who will not render the partnership ineligible to “elect out” of the new regime.

- Carefully consider each person or entity before they are admitted to the partnership to determine whether the new admittee will render it ineligible to “elect out” of the new regime.

- If a partnership cannot "elect out" of the new audit regime, consider:
  - Amending the partnership agreement so that the partners direct (by the terms of the agreement) the PSR to elect the alternative payment system in all cases. Each partner should affirmatively approve this amendment and agree to be so bound; and
  - Amending the partnership agreement so that the partners from each review year (in the ownership proportions they hold during each such review year) bear any economic burdens of an IRS examination, rather than the partners for the tax year in which the examination concludes (in the ownership proportions they hold at the conclusion of the audit). Accordingly, consideration should be given to adding: (i) a provision expressly allowing the partnership to withhold distributions from any partner in order to pay the resulting tax; (ii) a "clawback" provision requiring that the partners from the review year indemnify the partnership and other partners from their share of the resulting liability; (iii) a provision expressly allowing the partnership to set up a reserve in anticipation of a tax liability; and/or (iv) a provision expressly providing a method by which any tax liability that cannot be recovered from departed or reduced-interest review-year partners is allocated and assumed by the remaining partners.
- The "Tax Matters Partner" (under the old regime) needs to be replaced with a PSR. Adding a totally new PSR provision should be considered when drafting or amending any partnership agreements. Such a provision should include, but not be limited to, the following:
  - An obligation of the PSR to notify partners, including both current and any former partners who could be impacted, of any IRS audits;
  - An obligation of the PSR to keep the partners informed of the audit as it progresses;
  - The granting of authority to the PSR to resolve audits and make decisions about tax matters;
  - A release of the PSR of all liability relating to audits, provided the PSR acts in good faith;
  - A requirement that the partners promptly provide the PSR with any needed information and/or documentation for purposes the audit;
  - An agreement of each of the partners to file amended returns and/or comply with any audit results, including paying their share of any resulting tax liability; and
  - Specifically directing or limiting the authority of the PSR with respect to "electing out" of the new audit regime and/or elect the alternative payment system.[7]

In addition to amending current or existing partnership agreements, partnerships should consider notifying each of their partners of these new rules and the date upon which these rules will be effective. Further, before admitting new partners, partnerships should advise the prospective partners of the audit rules applicable to the partnership, along with any

transferability restrictions placed on the partners in the partnership agreement relating to the partnership's ability to "elect out" or use the alternative payment system.

While it is tempting to immediately amend partnership agreements to deal with the anticipated changes created by the new audit rules, taxpayers and partnerships may not want to implement any changes until Treasury issues regulations.

Preliminary Suggestions for Partnerships

For existing partnerships, the following should be considered:

- Appoint a PSR to act on behalf of the partnership in years in which the partnership may be subject to the new audit regime (i.e., if it is ineligible or if it fails to "elect out" of the new audit regime).

- Determine if the partnership is eligible to "elect out" of the new audit regime. To be eligible, the partnership:
  - Must issue 100 or fewer Schedule K-1s (for this purpose, all Schedule K-1s issued by S corporation partners are counted); and
  - Must not have any partners that are trusts or entities taxed as partnerships.[8]
- If a partnership is eligible to "elect out" of the new audit regime:
  - Consider obtaining the written approval of the partners to "elect out"; and
  - Consider amending the partnership agreement so that transferability of partnership interests is restricted to only eligible partners.
- If a partnership is **not** eligible to "elect out" of the new audit regime:
  - Determine (once regulations are issued) whether the alternative payment system is available and consider whether the partnership should elect into it in all cases or at the discretion of the PSR;
  - If the alternative payment system is not available, consider amending the partnership agreement to address responsibility for any tax liability resulting from review year audit adjustments, including addressing changes of partners and partnership interests between the review year and the year in which the audit concludes; and
  - Add a provision to the partnership agreement to specifically address PSR issues (as discussed above).

For newly created partnerships, the following should be considered and addressed:

- Whether the partnership will be initially eligible to "elect out" of the new audit regime and, if so, whether to impose transfer restrictions on partnership interests to restrict transfers only to eligible partners;

- Appointment of a PSR to act on behalf of the partnership in years in which the partnership may be subject to the new audit regime (i.e., if it is ineligible or if it fails to "elect out" of the new audit regime);

- Specifically directing or limiting the authority of the PSR with respect to "electing out" of the new audit regime and/or elect the alternative payment system; and

- Making appropriate disclosures to prospective partners regarding the foregoing.

Take the Time Now to Plan Ahead

Even though the new audit regime does not officially come into play until 2018, partnerships and entities taxed as partnerships need to consider its impact and take appropriate action sooner than later. Waiting until 2018 may be disastrous.

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[1] For purposes of these materials, the term "partnership" will include limited liability companies ("LLCs") taxed as partnerships and the term "partner" will include the members of such LLCs.

[2] Eligible partners include individuals (other than non-resident aliens), C corporations, and estates of deceased partners.

[3] The election appears to be a year-by-year decision reflected on the partnership's IRS Form 1065.

[4] The exact method by which a partnership may "elect out" will likely be set forth in Treasury Regulations, but, as stated above, no regulations have been published by Treasury to date.

[5] For partnerships with S corporation partners, the number of Schedule K-1s issued by the S corporation partners counts toward the "100 or fewer" requirement.

[6] The new statutory regime directs the Treasury to establish procedures under which the imputed underpayment may be modified in certain circumstances.

[7] By definition, the PSR has the authority to make these elections on behalf of the partnership. Thus, a partnership agreement may wish to include a provision specifically directing the PSR to always make these particular elections when available or to require the PSR to make these elections at the direction of the partners or governing board.

[8] The statute is unclear whether a disregarded entity that has an otherwise eligible owner is an eligible partner for this purpose. Likewise, it is not clear whether a revocable living trust which is disregarded for income tax purposes during the life of the trustor is an otherwise eligible partner. Until regulations are issued by Treasury, we do not know these answers.

Tags: Bipartisan Budget Act, New Partnership Audit Rules, partnership taxation, President Obama, Treasury Regulations